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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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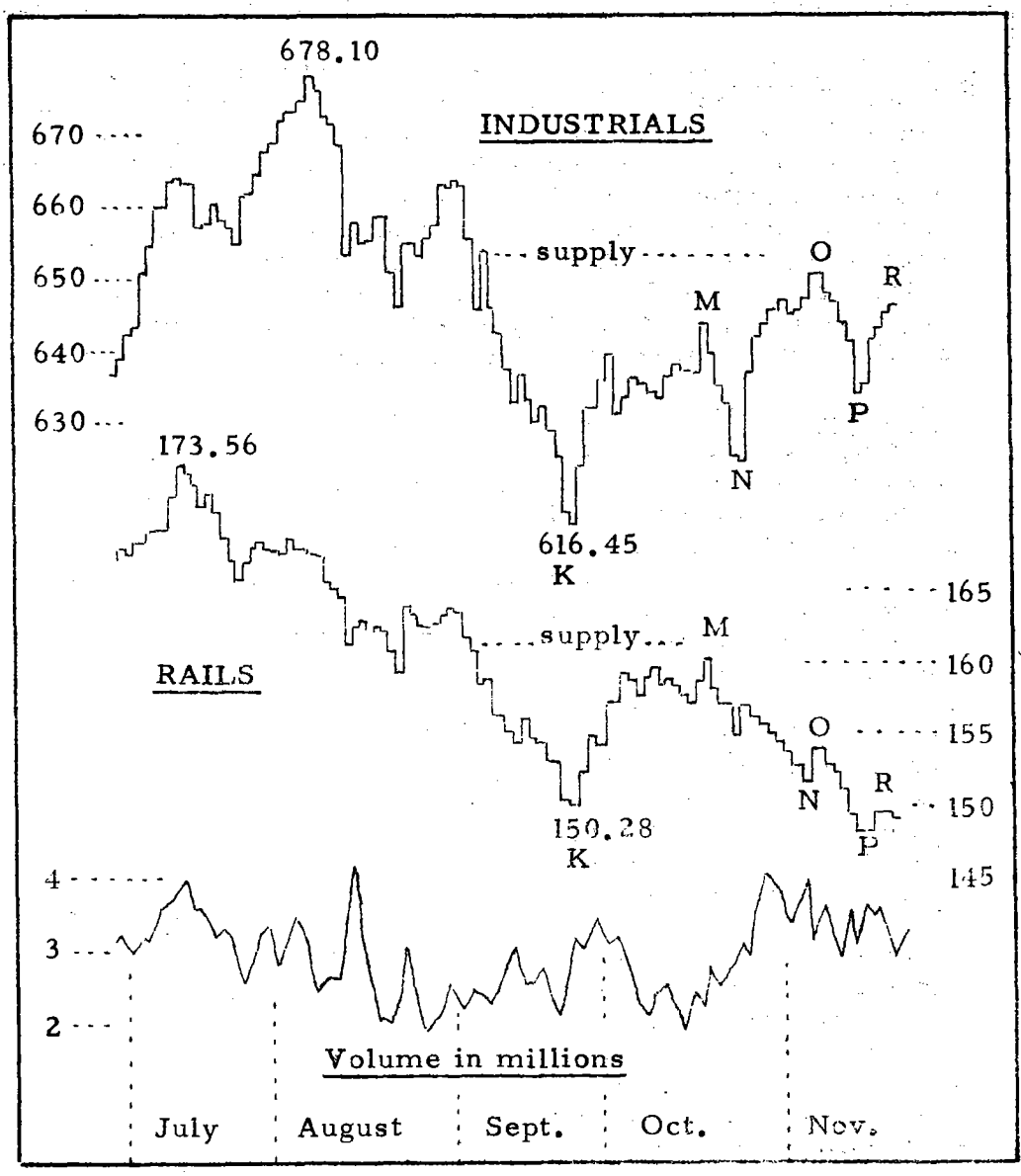
THE RECENT MARKET PICTURE. Following the September 22 reaction lows (K - see chart below), the two Averages advanced sharply, Rails hitting a recovery high of 159.99 on October 16 (M) and Industrials touching a recovery high of 650.92 on November 6 (O). The price movements during this period are well worth analyzing in detail.

Having hit their peak at M, Rails entered a long, shallow decline punctuated by a series of rather unusual one day rallies. On November 13 Rails violated their 150.28 reaction low point established at K. In so doing, they provided one half of a bear signal. As stated in Letter 84, however, the indications of one average unconfirmed by the other are meaningless under the Dow Theory.



The Industrials rallied with Rails to M; they also broke with Rails to N. Following N, however, the Industrials engaged in a surprising advance of their own, and it was here that the most spectacular divergence (the two averages moving in opposite directions) of recent years was seen. Between October 26 and November 5 Rails declined while Industrials advanced on seven out of eight successive days. The solo Industrial performance carried that Average to 650.92 (O), but Dow Theorists, refusing to draw conclusions from the action of one Average alone, waited for the inevitable reunion. During the divergence (see Letter 83), I remarked, "Often, subsequent to an extended period of divergence the key to the underlying trend is the direction which both Averages take on the first few days of 'in gear' movement." As has been true in all previous instances the two Averages soon got in gear (moved together), and the direction was down. Between November 6 and November 18 Industrials and

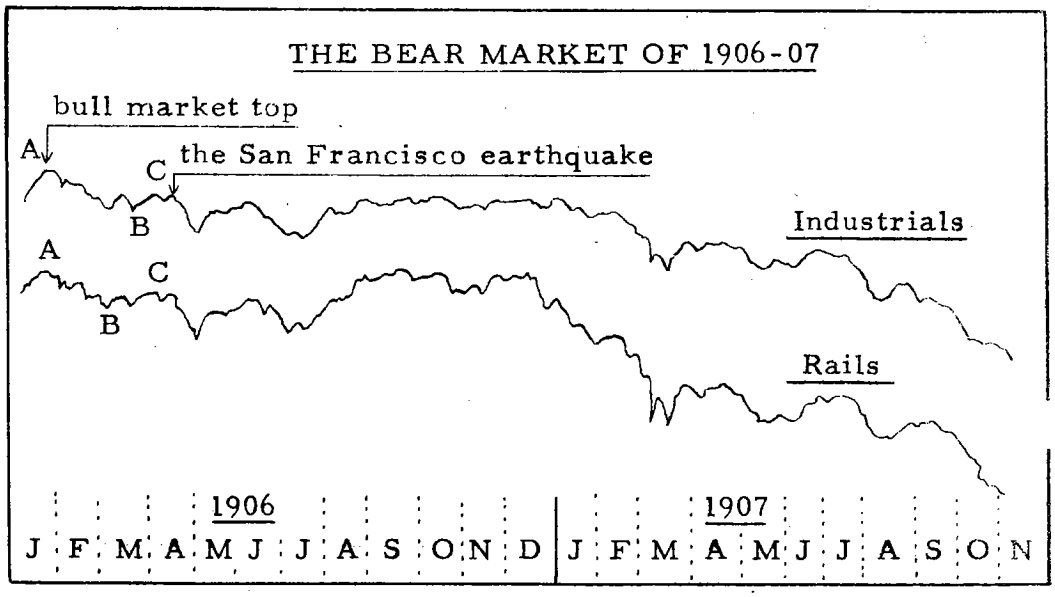
Rails sustained losses of 15.37 and 7.49 points respectively.

The movement of the Rail Average since its 173.56 high has been most interesting. The long swing down from 173.56 to the reaction low at 150.28 was extended and rather shallow, and it was punctuated with numerous sharp, short-lived rallies. Following the 150.28 low, a violent five day rally wiped out 40% of the entire reaction loss. A "line" formed, and when Rails broke below the line another sloping decline took Rails under their 150.28 September low. As mentioned in Letter 80, these violent rallies and plodding declines are a most unusual phenomenon in a bull market. The action of the Averages during bull markets tends to be quite the opposite; advances in bull markets are usually long and plodding while reactions tend to be sharp and rapid.

It is also interesting to note that on the advance from K, both Averages halted directly under their previous areas of distribution. These areas are marked "supply" on the chart. This suggests that as the Averages approached important earlier distribution levels, enough new selling came out so that the market became "saturated", and the advance was halted. When this selling continued the halt turned into a decline. The stock above the lines marked "supply" can be considered as a mass of overhead shares which must be absorbed before an advance can take the Averages to new highs. In general, it takes heavy and consistent buying (volume) to plow through such a barrier of overhanging supply. Obviously, the recent advance was not accompanied by this type of relentless buying.

CURRENT MARKET. The P-R rally retraced 70% of the Industrial losses sustained on the O-P decline, 38% of the Rail losses -- a perfectly normal correction. As mentioned in Letter 84, Rails are consistently showing up as the weaker Average. Volume contracted as prices advanced on the P-R rally, which was not bullish. The Rails have persistently refused to better even minor preceding highs such as R (149.41 or O (154.14). A significantly bullish movement would be an Industrial bettering of O (650.92) with rails bettering first R and then O. A decline on greatly decreased volume with one or both Averages holding above the P points (Industrials 634.45, Rails 146.65) would be a hopeful sign and could well be a trading "buy-spot". A violation of the P points on increased volume would signify that the minor and secondary trend continues to be down.

TWO FRIENDS. Let us picture two knowledgeable Dow Theorists, a bull and a bear, discussing the market. The bull speaks, "As far as I'm concerned, the Dow Theory is saying it's a bull market until proved otherwise. The otherwise, of course, is a bear signal -- a high volume breaking of the September lows. The Rails have already broken, but look at the way the Industrials have resisted -- and this in the face of the steel situation, the poor export picture, the tight money, the lower farm income. No, my friend, you will have to admit that Industrials are behaving beautifully in the face of bad news. The Industrial Average is saying that there are better things ahead. I can also point to a few recent upside days on expanding volume -- rather impressive. And as far as Rails are concerned, why there's a coming strike in the industry, and the carriers are merely discounting the worst ahead. In fact, I think it's amazing the way Industrials do hold up in the face of a possible rail strike. Just give me one upward zig-zag in the



Averages with expanding volume, and I'm going to buy some more stocks; I think we've seen the worst."

The bear shakes his head, "Everything you say makes sense. But I'd like to present a little theory of my own. Here's a chart of the 1906 top and the bear market that followed (the "Panic of 1907"). The 1903-06 bull market topped out in January, 1906 (see chart, page 2), following which the Averages commenced their first bear leg (A-B). The bear swing ended at B on the chart and a correction (B-C) followed. Again the market turned down, and a discussion by Hamilton appeared (Wall Street Journal) in which he stated that if the two Averages closed below B a bear market would be signaled. Two days later an act of God occurred, the great San Francisco earthquake. The panic that ensued took the Averages to new lows and a bear market was signaled.

"The nation sustained huge losses, the insurance companies were rocked on their heels, and the general opinion was that a market collapse was imminent. No collapse came. 'Paradoxically as it may sound,' wrote Rhea, 'there is good reason for believing that the disaster was responsible for holding up the Averages during 1906 rather than pulling them down. In barometric fashion, the price movement was foreseeing that the insurance companies would muddle through -- that losses would be generally paid, and that courageous citizens of the coast metropolis would begin rebuilding their city...this condition greatly stimulated business activity.'

"Rhea added, '..we know that the basic factor responsible for the decline in the first half of 1906 was a forthcoming credit collapse....The decline in business activity, which was evidently caused by tight money, did not become very pronounced during 1906, and stocks did not go into any decline.' "

The bear continues, "It has occurred to me that the longest steel strike in history is very much like an act of God; it came as a surprise. If a bear market did start on July 8, 1959, the first bear swing ended September 22. But then what happened? The nation was jarred by the severity of the steel strike, and many economists were (and still are) saying that a continuing steel strike following Taft-Hartley would be disastrous. We must admit that the possibility of a new steel strike exists; yet, what are the Averages saying? They are saying that no matter how bad the steel picture becomes, that situation will not set off a bear market in itself. The Industrial Average, by holding above its September low, is saying that the steel pessimists are wrong. In other words, I believe that the steel picture is holding up the market. And what is more, if the men walk out of the plants after the 80 day period, the Industrials will continue to hold. We are not, in fact, going to see a bear market until the steel strike is permanently settled. Just as the San Francisco earthquake postponed a bear market in 1906, the steel strike is postponing a bear market now.

"Finally," says the bear, "everybody is expecting a great surge on the steel settlement, yet I have the theory of contrary opinion on my side. What will cause the bear market, you ask? Maybe tight money, maybe something else. But if everything is going to be so wonderful, why aren't we seeing new highs on the Averages in view of an eventual steel settlement?"

"Lord help us," says the bull, "I hope you're wrong."

"So do I," says his friend.

FAILURE TO CONFIRM. (Confirmation -- the penetration of previous points by both Averages). One of the least understood parts of Dow Theory is that which deals with the failure of one Average to confirm its companion. In brief, failure to confirm can never provide positive indications -- only negative ones. (See "Technical Analysis of Stock Trends" by Edwards and Magee - Page 29). Positive Dow Theory signals are only given when the two Averages actually do confirm.

In the current market, for example, the failure of rails to confirm the Industrial advance above point M did not provide a bearish signal, it merely cast doubt upon the validity of the Industrial advance, N-O. Conversely, the failure of Industrials to confirm the Rail violation of K does not afford a positive bullish indication. Yet it negates any bearish conclusion which may be drawn regarding the downward penetration of Rails.

A positive and bullish indication would be given if Rails turned up and bettered their M point (159.99). A definite bearish indication would be given if Industrials turned down and violated their preceding low point at N (625.59).

A widely read service recently stated that the Industrials' refusal to confirm the downward trend in rails "is extremely bullish" for the longer term, and that this will be followed in time by a great market "upswing". Such an upswing may be forthcoming, but this service's reasoning for the upswing must be classified as wishful thinking.

THE COMPETITION. One of the arguments against the Rails as an indicator of shipping is that they are losing out to the airlines and truckers. "Put some of the new stocks in the Rail Average", say the Rail-detracters, "and you'll have a real indication of transportation." Strangely, however, the airlines have recently been hitting new lows along with the Rails while McLean Trucking has also been no ball of fire.

SPLITS. If stocks are to be distributed now or in the future, certainly every effort is being made to bring them within the range of the public's pocketbook. Over the last few weeks the following numbers have been "split" in halves or thirds: Westinghouse, Allied Chemical, Goodyear, Firestone, Continental Steel, American Machine & Foundry, Granite City Steel, Stewart-Warner and Cocoa Cola. One wonders how much longer I.B.M. (one of the funds' big holdings) can resist the trend?

CRYSTAL BALL DEPARTMENT. From a circular sent me by one of the nation's largest investment services -- "10 'STOCKS FOR ACTION' TO BUY FOR THE UNPRECEDENTED PROFITS BOOM OF 1960."

(Above written morning of November 23rd)

(Following written November 23, after the close) Today Industrials closed up 1.23 and Rails down 1.11 with volume expanding to 3.4 million shares. The "tug-o'-war" between Rails and Industrials continues with Rails (so far) seeming to resist bettering even the most minor preceding peaks. I do not think we will see any impressive Industrial strength until Rails get "in gear" on the upside. An Industrial violation of P (634.46) would provide the first sign of danger in the current structure.

Thirty Stocks Used in Dow Jones Industrial Averages are:		
Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	St Oil of N. J.
Amer Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth
Twenty Railroad Stocks Used are:		
Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific
Del & Hudson	N. Y. C. & St. L.	